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IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

SOUTH CENTRAL BELL TELEPHONE COMPANY, *et al.*,
Petitioners,

v.

STATE OF ALABAMA AND
STATE DEPARTMENT OF REVENUE,
Respondents.

On Writ of Certiorari to the Supreme Court of Alabama

BRIEF OF COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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BRIEF OF COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTRODUCTORY STATEMENT

The brief is submitted by the Committee On State Taxation as *amicus curiae* in support of the Petitioners in the above-quoted matter.*

* No Counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus curiae*, its members or counsel has made a monetary contribution to the preparation or submission of this brief. Petitioners and Respondents have consented to the filing of this brief and their letters have been filed with the Clerk of this Court.

INTEREST OF *AMICUS CURIAE*

The Committee On State Taxation ("COST") is submitting this brief because its members have expressed significant concern over the procedural ramifications to state tax appeals if the Alabama Supreme Court's and Circuit Court's decisions remain as law and because its members have always been at the forefront of the fight against discriminatory state taxes. COST's membership consists of over 500 multistate corporations involved in interstate and international commerce. COST is a nonprofit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce and was separately incorporated on January 1, 1992. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. In the last five years, COST has filed at least ten briefs with this Court expressing its concerns over discriminatory and unconstitutional state tax systems.[1] Many of COST's members are engaged in business in the State of Alabama and, thus, have a particular interest in the validity of Alabama's franchise tax system. Further, the Alabama court's expansive application of the doctrine of *res judicata* directly challenges many members' historic approach to the management of tax litigation in Alabama and elsewhere. Finally, all COST members are injured by unconstitutional state burdens on interstate commerce through increased costs and decreased market access.

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[1] *E.g., NACCO Indus. v. Tracy*, 118 S. Ct. 882 (1998); *Newsweek, Inc. v. Florida Dep't of Revenue*, 118 S. Ct. 904 (1998); *Koch Fuels v. Clark*, 117 S. Ct. 301 (1996); *Thiokol Corp. v. Mich. Revenue Div.*, 117 S. Ct. 2448 (1997); *General Motors Corp. v. Tracy*, 519 U.S. 278 (1996); *GMC v. Kansas City*, 516 U.S. 909 (1995); *ANR Pipeline Co. v. Kan. Director of Property Valuation*, 513 U.S. 917 (1994); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994); *Reich v. Collins*, 513 U.S. 106 (1994); *Geoffrey, Inc. v. S.C. Dep't of Revenue and Taxation*, 510 U.S. 992 (1993).

SUMMARY OF ARGUMENT

This Court has accepted review of two issues raised by the Petitioners: (1) does the Alabama franchise tax violate the Commerce Clause and (2) did the Alabama courts violate Petitioners' Due Process rights by barring Petitioners' case under the doctrine of *res judicata*. Based on the straight forward application of this Court's prior decisions, the answer to both of these questions is "YES". First, Alabama's franchise tax violates the Commerce Clause because on its face it imposes a different tax system on out-of-state companies than on in-state companies and in fact it imposes a higher incidence of tax on out-of-state companies than on in-state companies. Decades U.S. Supreme Court precedent, including *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), hold that under the Commerce Clause a state may not discriminate in its tax system in favor of local companies over out-of-state companies. Second, the Alabama Courts'[2] decision that Petitioners' case is barred on *res judicata* grounds because of an earlier case challenging the same franchise tax abrogates the Petitioners' constitutional rights under the Due Process Clause to a day in court. The Petitioners were not parties to the earlier case, had no legal relationship with the parties in the earlier case, and had no notice of, and were not even aware of, the earlier case until after a decision by the Alabama Circuit Court. This Court only two years ago, in *Richards v. Jefferson County*, 517 U.S. 793 (1996), instructed the Alabama courts that they cannot apply *res judicata* if the cases at issue did not involve the same taxpayers.

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[2] Because it is not clear whether the Alabama Supreme Court's decision against the Petitioners was based on Commerce Clause grounds or on the *res judicata* grounds relied on by the Circuit Court, *amicus* has referred to the judicial body deciding the *res judicata* issue as merely "the Alabama courts".

SUMMARY OF THE TAX

Alabama's corporate franchise tax applies a different tax base and a different tax rate to out-of-state corporations than to in-state corporations. In-state corporations (corporations incorporated in Alabama, Ala. Code § 40-14-40 (1998)), are subject to franchise tax solely on the par value of their stock (the rate is $10 per $1,000). Ala. Code § 40-14-40 (1993). Par value is a figure chosen by the issurer (*i.e.*, taxpayer) and is basically an artificial amount, generally unrelated to either the actual capital of a corporation or the original investment in a corporation. As a result of par value constituting the entire base of the tax for in-state corporations and the value being a number assigned by the taxpayer, in-state corporations have virtually carte-blanche to determine their own Alabama franchise tax burden.

On the other hand, out-of-state corporations (corporations incorporated in states other than Alabama, Ala. Code § 40-14-41(a)), are taxed on their actual capital employed in Alabama (the rate is $3 per $1,000). § 40-14-41(b). "Actual capital" includes: (a) outstanding capital stock; (b) surplus and undivided profit; (c) long-term debt; (d) certain related party debt; and (e) accelerated depreciation. *Id.* Inasmuch as the amount of capital a corporation employs in Alabama is dictated by business decisions generally independent of tax decisions, out-of-state corporations are not able to manipulate their franchise tax base in Alabama. The predictable result of such a tax system is that in-state corporations pay less franchise tax than if they had been incorporated outside of Alabama.

ARGUMENT

I. THE ALABAMA FRANCHISE TAX VIOLATES THE COMMERCE CLAUSE BECAUSE IT IMPOSES A DIFFERENT AND MORE BURDENSOME FRANCHISE TAX ON OUT-OF-STATE CORPORATIONS THAN ON SIMILARLY SITUATED IN-STATE CORPORATIONS.

There can be no genuine argument that the Alabama franchise tax is constitutional under the Commerce Clause. Petitioners have fully explained the reasons that the Alabama franchise tax is unconstitutional and *amicus* will not repeat their arguments here. *See Petitioners' Brief*, pp. 25-32. However, *amicus*, as an organization devoted to the abolition of discriminatory state taxes, will briefly outline what it sees as this Court's bright-line rules for establishing a non-discriminatory tax and how the Alabama franchise tax has violated those rules.

On its face, the Alabama franchise tax impermissibly discriminates between out-of-state and in-state corporations in violation of the Commerce Clause. A tax is discriminatory if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992). The Alabama franchise tax employs two different tax bases and which tax base a taxpayer is subject to is dependent entirely on which side of the Alabama state line a corporation is incorporated. For taxpayers incorporated in Alabama, the tax base consists of an arbitrary measurement unrelated to actual business activity and controlled and chosen by the taxpayer itself. For taxpayers incorporated outside Alabama, the tax base is computed based on the taxpayer's capital in Alabama which is dictated by business decisions. This Court has repeatedly stated that facial discrimination against interstate commerce is virtually

per se invalid, *see e.g., Fulton Corp.*, 516 U.S. at 331; *Oregon Waste Systems, Inc. v. Dep't of Envtl. Quality*, 511 U.S. 93, 99 (1994), and, as such, the Alabama franchise tax must be unconstitutional.

The Alabama franchise tax also discriminates *in fact* against out-of-state corporations. This Court has a clear substantive rule that "no State, consistent with the Commerce Clause, may impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (citations omitted). The Alabama Circuit Court specifically found that the record proves that the Alabama franchise tax imposes a higher level of taxation on out-of-state corporations than would be imposed on such corporations if they were in-state corporations. *Petitioners' Appendix B*, 21A-22A. As in all of the other discrimination cases addressed by this Court, the "obvious effect of the tax is to extend a financial advantage [to the in-state corporations] at the expense of the [out-of-state corporations]." *Id.* at 331. This higher level of taxation directly and negatively affects an out-of-state corporation's profits and pricing.[3] Such blatant discrimination has never been tolerated by this Court.

[3] COST's members have repeatedly expressed disbelief that a tax that so blatantly puts out-of-state corporations at a competitive disadvantage by increasing their costs vis-à-vis in-state corporations is still being enforced. The foundation for the Commerce Clause has always been to foster an open market between the states. Such a market can only exist through free and unburdened competition. This Court has consistently recognized the importance of competition to our national economy and the contribution of the Commerce Clause to the cultivation of competition. *See H. P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949) ("Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality"). To the extent that a company incorporated outside of Alabama pays more in tax than a company incorporated within Alabama, competition is diminished and another step is taken toward state economic balkanization.

Further, it is now clear that Alabama's franchise tax on out-of-state corporations cannot be supported under the compensatory tax doctrine as complementary to the domestic shares tax. In *Fulton Corp.*, this Court specifically stated that a tax on corporate stock was not the functional equivalent of an income tax on the issuer and, thus, the compensatory tax doctrine did not apply. This Court went on to state that "we doubt that [a showing of the requirements of the compensatory tax doctrine] can ever be made outside the limited confines of sales and use taxes." *Fulton Corp.*, 516 U.S. at 344. If such a showing ever could be made, it was not made here as Alabama offered absolutely no proof as to the actual economic equivalency of the foreign franchise tax and the domestic shares tax.[4]

In sum, the Alabama franchise tax is unconstitutional under the Commerce Clause because it imposes, both on its face and in fact, a greater burden on out-of-state corporations than on in-state corporations with no equivalent in-state tax to compensate for this burden. The tax is a classic example of a discriminatory tax and is therefore abhorred by this Court's constitutional jurisprudence.

[4] See Petitioners' Brief at p. 30 for an application of the three requirements for a compensatory tax under *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 103 (1994).

II. ALABAMA HAS DENIED THE PETITIONERS ACCESS TO ITS COURTS UNDER THE DOCTRINE OF *RES JUDICATA* DIRECTLY IN CONTRAVENTION OF THE U.S. SUPREME COURT'S 1996 RULING THAT THIS INTERPRETATION OF *RES JUDICATA* VIOLATES THE DUE PROCESS CLAUSE.

Using the doctrine of *res judicata,* the Alabama courts prohibited Petitioners from pursuing their case because an earlier case had held that the challenged tax was constitutional. *Amicus* fears that the practice followed by the Petitioners of holding their case in abeyance pending the resolution of a lead case, which is standard practice in state tax controversies, led to the *res judicata* ruling. Such a ruling directly, unnecessarily, and unconstitutionally threatens the continued use of this practical and efficient procedure.

The procedural issue that *amicus* is concerned about arose because one of the taxpayers asked to hold its case in abeyance until a case that was ahead of it procedurally, *White v. Reynolds Metals Co.*, 558 So. 2d 373, was finally determined. The affected taxpayer agreed to this procedure because there was a possibility that the *Reynolds* case would resolve the constitutionality of the Alabama franchise tax and make further taxpayer litigation unnecessary. This procedure saved money and time for both the Petitioners and the Alabama Department of Revenue. Ultimately, the Alabama Supreme Court determined in *Reynolds* that the Alabama franchise tax was constitutional and, thus, ruled against the taxpayers. This Court denied *certiorari* in *Reynolds*, 496 U.S. 912 (1990), and the Alabama Supreme Court decision became the final adjudication of that case.

Following the final determination of the *Reynolds* case, several distinguishing events occurred that differentiated the Petitioners' case from *Reynolds.* First, the Petitioners

completed an extensive statistical study that proved that out-of-state corporations in fact paid more franchise tax than in-state corporations. This study and its conclusion were adopted as a finding of fact by the Alabama Circuit Court; thus, its validity is no longer in question. *See Petitioners' Appendix B,* 21a-22a. Such a study had not been undertaken by the taxpayers in *Reynolds.* Second, this Court decided several pivotal Commerce Clause cases, including *Fulton,* emphasizing that no discrimination was tolerable under the Commerce Clause and that the compensatory tax doctrine was to be narrowly applied. Notwithstanding these subsequent events and the lack of connection between the Petitioners and the taxpayers in *Reynolds,* the Alabama courts found that as a result of *Reynolds,* Petitioners' claims were precluded under the doctrine of *res judicata.*

Amicus is concerned that the procedure of holding a case in abeyance while another case finishes the appellate process was the reason that the Petitioners were found to be barred by *res judicata.* One judge in the majority specifically characterized this procedure as the basis for his decision. *Opinion of Justice Maddox* concurring specially. *Petitioners' Appendix A,* 1a-6a. Holding a case in abeyance pending a decision in a lead case is a common practice utilized by taxpayers and taxing authorities alike to preserve resources and allow for the orderly administration of taxes. Typically, a taxpayer whose case is being held in abeyance does not participate in any way with the lead case. In most circumstances, the lead case resolves all issues for the tax authority and other taxpayers. In these cases, the losing parties will usually withdraw any remaining claims. However, in some cases, as represented here, the lead case does not ultimately address all of the positions of the follow-up taxpayers. When this happens, taxpayers expect to and in fact have been able to proceed with their own case. Inasmuch as parties to cases procedurally behind a lead case do not know until the lead

case has been finally determined whether all of their own claims will actually be addressed, such parties do not have sufficient information at the beginning of their case to choose whether to be bound by the lead case or to proceed independently with their own. The system of holding a case in abeyance without forfeiting the right to pursue one's own case strikes the appropriate balance between judicial economy and the preservation of the right to a hearing. The Alabama court's decisions have disrupted this balance.

The ability to hold a case in abeyance without forfeiting the right to pursue the case in court is necessary for the rational operation of the courts. Frequently, when a tax is challenged as invalid, a significant number of taxpayers will file refund claims to protect their interest in the event that the tax is struck down. At the same time, the taxing authority will continue to assert the validity of the tax and issue assessments against those taxpayers who do not comply. Such claims and assessments must be filed before the concluion of the lead case because the statute of limitations on the refunds and assessments would otherwise expire.[5] If a taxing authority is required to litigate each of these claims in full while waiting for the lead case to be decided, then the tax authority will be quickly overwhelmed by the volume of cases involving one, isolated issue. Even if only a few cases are pursued, this will still lead to an increased burden on strained government staffs. The administrative and judicial tribunals responsible for hearing the refund cases and appeals will similarly be overwhelmed with a burdensome case load. Finally, it is a financial drain on both taxpayers and the tax authority to litigate each case rather than waiting for the ultimate outcome of one lead case.

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[5] The need for taxpayers to file a protective refund claim before challenges to the tax have reached fruition has recently been exacerbated by the trend among the states to impose very short statute of limitations on such claims. *See, e.g.*, Mich. Comp. Laws § 205.57a(6) (90 days); N.C. Gen. Stat. § 105-267 (30 days).

It is *amicus's* expectation that absent intervention by this Court, Alabama's interpretation of *res judicata* will be adopted by other states and taxpayers will be forced to protect their interests in all jurisdictions, not just in Alabama. If an interpretation that a taxpayer has agreed to be bound by a prior taxpayer's case by merely agreeing to hold a case in abeyance, regardless of the facts in that case or intervening contrary decisions, is not explicitly invalidated, taxpayers will pursue their cases rather than hold them in abeyance even though to do so may be a repetitive exercise resulting in a waste of taxpayer's and government's time.

As a result of the Alabama courts' decisions below, judicial and economical savings through the abeyance procedure will be unavailable to the sensible taxpayer. No informed taxpayer will agree to hold a case in abeyance knowing that such a move may effectively foreclose the opportunity to litigate one's own facts, under one's own legal theories, with one's chosen legal counsel. Thus, from a practical standpoint, the anticipated effect of the Alabama courts' decisions is patently unworkable and could lead to disruption in the tax judicial system.

From a legal perspective, the Alabama courts have confused the doctrine of *res judicata* with the concept of precedent and *stare decisis*. The *Reynolds* case did precede the Petitioners' case and in the absence of distinguishing precedent or facts might have provided a legal basis under the doctrine of *stare decisis* for ruling against the Petitioners on the merits. But the Alabama courts instead invoked *res judicata* to prevent the Petitioners from even receiving a ruling on the merits on the theory that Petitioners' claims are actually precluded by *Reynolds*. Neither claim nor issue preclusion can possibly apply as between *Reynolds* and the Petitioners' case because the cases involved different taxpayers, different tax years, different facts, different proof, and new controlling precedent. Such a use of *res judicata* is not only inappropriate, it is also specifically prohibited by the Due

Process Clause of the Fourteenth Amendment and by the prior decisions of this Court.

This is not the first time that Alabama has attempted to use *res judicata* to deprive taxpayers of their right to protest a tax. It is also not the first time that this Court has considered Alabama's application of *res judicata.* In *Richards v. Jefferson Cty.*, 517 U.S. at 802, a case also involving Alabama taxpayers and the Alabama courts, this Court held that unrelated parties could not, consistent with due process, be held bound by *res judicata* principles. Notwithstanding the clear mandate in *Richards,* the Alabama courts have failed to note any of the traditional elements of *res judicata* in the current that this Court has accepted as fulfilling due process requirements. The Petitioners were not parties in the *Reynolds* case, had no privity with the parties in the *Reynolds* case, and did not have any special relationship with the parties in the *Reynolds* case. The taxpayers in the *Reynolds* case were not representatives of a class covering the Petitioners nor was there any special judicial procedure, such as bankruptcy, that would require the Petitioners to be bound by the judgment in *Reynolds.* The taxpayers in *Reynolds* did not consult with Petitioners regarding the case or seek in any way to determine and protect the Petitioners' interests. As such, the Alabama courts have violated the Petitioners' due process rights by binding the Petitioners to a case in which they had no legal connection.

If the Petitioners cannot challenge the Alabama tax because of *res judicata* there appears to be no party that could challenge and invalidate the illegal tax. The result is that an obviously unconstitutional tax not only remains on the books, but continues to be enforced against all Alabama taxpayers. Currently there are numerous other taxpayers whose court cases have been put on hold until a final decision is reached in Petitioners' case. Based on the Alabama courts' reasoning, these taxpayers would be

similarly precluded from pursuing their rights if the Petitioners are foreclosed from the challenge. There are also dozens of refund claims pending at the administrative level. Are each of these claims precluded under *res judicata* principles because of the *Reynolds* (and now *South Central Bell*) case? At exactly what point will a taxpayer once again be able to challenge the tax? Two years; three years; ten years from now? And, in the interim, Alabama will continue to impose and enforce its unconstitutional franchise tax.

Prior precedent of this Court establish non-controversial and easily applicable rules for determining whether a tax violates the Commerce Clause and whether binding taxpayers to an earlier case is inconsistent with Due Process requirements. Applying these rules to this case leads to the irrefutable conclusion that the Alabama tax does discriminate against out-of-state taxpayers in favor of in-state taxpayers and thus violates the Commerce Clause and Petitioners' cases are not precluded under the doctrine of *res judicata* because they were not parties to the earlier case, their interests were not represented in the earlier case, and they did not have adequate notice of the earlier case..

CONCLUSION

The judgment of the Alabama Supreme Court should be reversed.

Respectfully submitted,

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